FILED
MAR 31 1980

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

NO. 79-1528

C. S. SMITH,
B. E. MCPHERSON,
BETTY F. CLOUD,
Petitioners

VERSUS

EQUITY NATIONAL INDUSTRIES, INC., ET AL.,
HERBERT A. ALCORD, ET AL.,
Respondents

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

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28 U.S.C. §1254(1)

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Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Fifth Circuit entered on the 28th day of December, 1979.

CITATION TO OPINIONS BELOW

The Order by the District Court for the Northern District of Georgia granting respondents' Motion For Summary Judgment is printed in Appendix "B" hereto

and is not reported in the official reports. The opinion of the Court of Appeals affirming the Judgment of the District Court for the Northern District of Georgia is printed in Appendix "A" hereto. The opinion by the Fifth Circuit Court of Appeals has not been reported in the official reports and has been marked "do not publish" by the Court.

JURISDICTION

The Judgment of the Fifth Circuit Court of Appeals, printed in Appendix "A" hereto, was entered on the 28th day of December, 1979. The jurisdiction of the Court is invoked under 28 U.S.C. §1254(1).

QUESTIONS PRESENTED

Petitioners filed suit alleging violations of §10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5 promulgated by the Securities and Exchange Commission in the transfer of stock acquired pursuant to a corporate merger. After extensive discovery was conducted by the parties, the District Court granted respondents' Motion For Summary Judgment on the grounds that petitioners had failed, as a matter of law, to exercise due diligence in investigating the financial status of the acquiring company in the merger. As a result, the Court held petitioners' claim was timed-barred by the applicable statute of limitations. The Fifth Circuit Court of Appeals, applying a longer statute of limitations period than the District Court, nevertheless affirmed on the merits.

The questions presented are:

(1) Whether, in a suit based on §10(b) of the 34 Act and Rule 10b-5, the casual relationship between the knowl- and information available to an investor and the exercise

of due diligence by the investor in utilizing this knowledge or information is a factual issue requiring jury determination.

(2) Whether, in a suit stating a cause of action under §10(b) of the 34 Act and Rule 10b-5, a due diligence defense can serve as the basis for the granting of summary judgment in favor of a defendant in the absence of extraordinary circumstances.

STATUTES INVOLVED

The pertinent portion of §10 of the Securities and Exchange Act of 1934, 15 U.S.C. §78j states:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange —
>
> . . .
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a National Securities Exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5, promulgated by the Securities and Exchange Commission, states:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of commerce, or the mails, or of any facility of any national securities exchange,

(1) To employ any device, scheme, or artifice to defraud,

(2) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security." 17 C.F.R. Par. 240.10b-5.

The pertinent portion of Rule 56(c) of the Federal Rules of Civil Procedure regarding motions for summary judgment states:

"The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidavits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law. 28 U.S.C. 56(c).

STATEMENT OF THE CASE

Petitioners herein, brought their action alleging violations of §10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5 as promulgated by the Securities and Exchange Commission. The factual background set forth in petitioners' complaint can be briefly summarized.

Petitioners acquired their stock in respondent , Equity National Industries, Inc., in October, 1968, when Hewett Studios, Inc., of which petitioners were stock-

holders and directors, merged with Equity. In return for the business and assets of Hewett, Equity agreed to issue 250,000 shares of Equity stock to the stockholders of Hewett. 150,000 shares were to be delivered at the closing of the acquisition, and a maximum of 100,000 shares more would be delivered, depending upon the earnings of Hewett, over the next four (4) years. As a result of the merger, petitioner Smith received a total of 7,401 shares of Equity stock — 5,934 shares on October 28, 1968 and 1,467 shares through earn-outs on March 31, 1970 and January 29, 1973. Petitioner McPherson received a total of 1,851 shares — 1,484 shares in October, 1968 and 367 shares through earn-outs. According to petitioners, it was not until 1974 that they became suspicious of the financial status of Equity and the inaccuracy and incompleteness of the representations made to them at the time of the merger in 1968.

Petitioners' complaint against the respondents as to material omissions can be summarized as follows:

(1) That immediately prior to the merger, Equity's insurance subsidiary had been informed by the Georgia State Department of Insurance that it was in violation of certain reserve fund requirements, and,

(2) That the significant portion of the earnings of the insurance subsidiary were derived from insuring the mortgage customers of a savings and loan association whose president was a member of Equity's board of directors.

On the 12th day of September, 1977, the District Court entered an order granting summary judgment in favor of respondents. The Court ruled that, as a matter of

law, petitioners had failed to exercise due diligence sufficient to toll the statute of limitations for initiation of their claim. This ruling was primarily based on a two question-two answer excerpt from one of the respondents' depositions. The deposition testimony relied on is set forth in the opinion of the Court of Appeals in Appendix "A", page 17.

Petitioners appealed the judgment of the District Court to the Fifth Circuit Court of Appeals which affirmed on the 28th day of December, 1979. Petitioners seek review of this decision under a writ of certiorari.

REASONS FOR GRANTING THE WRIT

WHETHER, IN A SUIT BASED ON §10(b) OF THE 34 ACT AND RULE 10b-5, THE CAUSAL RELATIONSHIP BETWEEN THE KNOWLEDGE AND INFORMATION AVAILABLE TO AN INVESTOR AND THE EXERCISE OF DUE DILIGENCE BY THE INVESTOR IN UTILIZING THIS KNOWLEDGE OR INFORMATION IS A FACTUAL ISSUE REQUIRING JURY DETERMINATION.

Petitioners contend that the causal connection between the information or knowledge available to the petitioners and the petitioners' obligation to exercise due diligence is a question of fact. The issue is whether the knowledge or information available to the petitioners was sufficiently related to the alleged fraudulent act or omission of the respondents to require the petitioners to exercise due diligence in attempting to uncover the alleged fraudulent act or omission.

In *J. I. Case Company v. Borak*, 377 U.S. 426, 84 S.Ct. 1552, 12 L.Ed.2d 423 (1964) the Court, in ruling on a case involving the use of alledgely false material in the solicitation of proxies, stated:

> "[T]he causal relationship of the proxy material and the merger are questions of fact to be resolved at trial, not here."

377 U.S. at 431.

Clarification is needed in the present context §10(b) and Rule 10b-5 for use by the lower Courts in deciding when information or knowledge an investor possesses can, as a matter of law, serve to warn the investor that due diligence must be exercised as to a particular financial aspect of a company.

In *Dzenits v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, 494 F.2d 168 (10th Cir. 1974) the Court stated the following:

> "Whether or not the plaintiff relied upon statements of reassurances made to her by Billington [an agent of defendant] is also a question of fact which the Court would have to resolve before determining that plaintiff had notice of facts which, in exercising due diligence, would have led to actual knowledge of the fraudulent activity. (citing *Goldenberg v. Bache & Co.* 270 F.2d. 675 (5th Cir. 1959)."

494 F.2d at 172.

The emphasis on causation established in *Dzenits v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, supra, has not been uniformly adopted. (see e.g. *Jones v. Ford Motor Company*, 599 F.2d 394 (10th Cir. 1979). The correctness of the view of the Court in *Dzenits* warrants the review of this Court with a thorough analysis of the relationship

between causation and due diligence under § 10(b) and Rule 10b-5 in the summary judgment context.

> WHETHER, IN A SUIT STATING A CAUSE OF ACTION UNDER § 10(b) OF THE 34 ACT AND RULE 10b-5, A DUE DILIGENCE DEFENSE CAN SERVE AS THE BASIS FOR THE GRANTING OF SUMMARY JUDGMENT IN FAVOR OF A DEFENDANT IN THE ABSENCE OF EXTRAORDINARY CIRCUMSTANCES.

Petitioners contend that the time has come for this Court to establish guidelines for the Circuit Courts of Appeal to utilize in analyzing and judging the circumstances under which an investor has or has not exercised due diligence under the Federal Securities Laws. The issue before the Court is whether an investor or a person in the investor's position, should reasonably have been aware of the existence of fraudulent activity in light of the information or knowledge available to them. The issue becomes whether the investor exercised due diligence based on available information or knowledge. Petitioners would urge the court to establish a standard to be applied in deciding the circumstances, if any, in which, as a matter of law, an investor has failed to exercise due diligence.

In *Dzenits v. Merrill Lynch, Pierce, Fenner and Smith, Inc.*, 494 F. 2d 168 (10th Cir. 1974), the Tenth Circuit laid down a strict standard to be applied in determining the plaintiff's due diligence. Recognizing the axiom that "both trial and appellate courts must consider factual inferences tending to show triable issues in the light most favorable to the existence of those issues," (citing *James v. Atkinson, Topeka, and Santa Fe Railroad Company*, 464 F.2d 173,175

(10th Cir., 1972), the Court ruled that summary judgment should not be granted to a defendant "if there is a viable issue of fact as to when the limitations period begin." 474 F.2d at 171. The Court decided that the question of due diligence is one of "constructive knowledge" and would therefore be a question of "fact". 474 F.2d at 172. The Court went on to state:

> "It would seldom, if ever, be possible for a judge to determine summarily when the injured person in a case such as this became fully aware that he or she had been victimized. An appraisal of the full testimony is generally called for."

Id.

The view adopted in *Dzenits* reflected the decision by the Fifth Circuit in the earlier case of *Azalea Meats, Inc. v. Muscat*, 386 F.2d 5 (5th Cir. 1967) rev'g 246 F.Supp. 780 (S.D. Fla. 1965). Discussing *Azalea Meats, Inc. v. Muscat*, supra, Professor Louis Loss stated the following:

> "The question of the reasonableness of the discovery steps taken by the plaintiff does not really lend itself to disposition by way of a motion by the defendant for summary judgment . . . [A]lthough discovery of fraud must be determined according to an objective rather than a subjective standard, 'the concept of due diligence is not imprisoned within the framework of a rigid standard'—among other things, the presence of a fiduciary relationship 'bears heavily on the issue of due diligence'—and inevitably the factual issue involves to some extent the state of mind of the person whose conduct is to be measured against the objective

> test, so that 'it is simply not feasible to resolve such an issue on motion for summary judgment." Loss, Securities Regulation VI, p. 3905 (1974) with quotes from *Azalea Meats, Inc. v. Muscat,* 386 F.2d, 5, 9-10 (5th Cir. 1967).

As the above quotation indicates, a court could arguably apply an objective, subjective or combination subjective-objective test in determining whether due diligence has been exercised.

Petitioners urge this Court to decide the degree of importance to be attached to the state of mind of an investor in determining whether due diligence has been exercised. The following quotation from *McNeal* v. Payne, Webber, Jackson & Curtis, Inc., 598 F.2d 888 (5th Cir. 1979) indicates the differences in opinion existing on this point:

> "As a matter of federal law, the period of limitations applicable to implied causes of action under section 10(b) and section 7 begins running only when the plaintiff discovers, or in the exercise of reasonable diligence should discover, the alleged violations. E. g., *Azalea Meats, Inc. v. Muscat,* 5 Cir., 1967, 386 F.2d 5, 8-9; *Vanderboom v. Sexton,* 8 Cir., 1970, 422 F.2d 1233, 1240. In reaffirming that rule, as originally set forth in this circuit in *Azalea Meats,* we observe that the test for determining when the period begins to run is an objective one, depending upon when the plaintiff should have discovered the alleged violation in the exercise of reasonable diligence, and not a subjective one, depending merely on when the plaintiff actually discovered the violation. We thus caution against reliance on dictum which speaks loosely of a subjective test. See *Hudak v. Economic Research Analysts, Inc.,* 5 Cir., 1974, 499 F.2d 996, 1000 n.5; *Sargent v. Genesco, Inc.,* 5 Cir. 1974, 492 F.2d 750, 758.

598 F.2d at 893, fn11.

In the opinion by the Fifth Circuit in the present case, Circuit Judge Kravitch stated:

> "In *Azalea Meats v. Muscat,* 386 F.2d 5 (5th Cir. 1967), the Fifth Circuit held that due diligence rarely could be determined on summary judgment because of the necessity of determining *the state of mind of the individual charged.* (emphasis supplied)

See Appendix "A", page 14.

Noting the apparent conflict between McNeal and the present case, petitioners urge this Court to clarify the test to be applied in summary disposition of §10(b) and Rule 10b-5 cases on due diligence grounds.

Additionally, petitioners urge this Court to consider whether or not the requirements of Rule 56(c) of the Federal Rules of Civil Procedure dictate a strict and limited utilization of summary judgment on due diligence grounds. In *Bachelor v. Legg & Co.,* 55 F.R.D. 557 (1972) the Court stated:

> "[E]ven though there may be no controversy over the basic facts, summary judgment should not be granted if the parties disagree as to the inferences which may properly be drawn. (citing *American Fid. & Cas. Co. v. London & Ins. Co.* 354 F.2d 214, 216 (th Cir. 1965).

55 F.R.D. at 561.

Petitioners case before this Court illustrates an impermissible departure from the basic principles which should be

applied upon motions for summary judgment in § 10(b) and Rule 10b-5 cases. An opinion by this Court is necessary as instruction for the lower Courts and is warranted by the important issues involved in the application of the federal securities laws.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

This _____ day of March, 1980.

RESPECTFULLY SUBMITTED,

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APPENDIX A

Decision of the United States Court of Appeals for the Fifth Circuit *(Smith et al v. Equity National Industries, Inc. et al,* Docket No. 77-3281, dated December 28, 1979).

KRAVITCH, Circuit Judge.

In this securities fraud action the district court granted the appellees' motion for summary judgment on the ground the appellants' Rule 10b-5 claim was time-barred by failure of the appellants to exercise due diligence in investigating the alleged fraud. We affirm.

Prior to 1968 appellants were shareholders and directors of Hewitt Studios, Inc. In October of 1968 the appellee Equity National Industries, Inc. [Equity] merged with the Hewitt Corporation and the appellants received shares in the appellee Equity in return for their shares of Hewitt stock. As amended, the appellants' single count complaint charged the appellees with violation of Rule 10b-5 in connection with the exchange of stock involved in the 1968 merger. Specifically, the complaint alleges that the appellees failed to disclose two material facts: (1) that appellee Equity's insurance subsidiary, Equity Life, had been informed by the Georgia State Department of Insurance that it was in violation of reserve fund requirements and (2) that a significant portion of the subsidiary's income was generated by insuring the mortgage customers of a savings and loan association whose president was a member of Equity's board of directors. This complaint, however, was not filed until 1975, almost seven years after the violation charged had occurred. Because the claim was filed well past the applicable statute of limitations, it became incumbent

upon the appellants to demonstrate that they had exercised due diligence in their investigation of the fraud in order to toll the statute of limitations until the fraud was discovered. On summary judgment the district court held that the appellants did not exercise due diligence and that the action was barred by the statute of limitations.1/

A motion for summary judgment under Rule 56 is appropriate only when the moving party has established that there is no genuine issue as to any material fact and that the movant is entitled to a judgment as a matter of law as applied to the established facts. Rule 56(c) F.R.C.P. In applying this standard both trial and appellate courts must consider factual inferences tending to demonstrate triable issues in the light most favorable to the existence of those issues. *See James v. Atchison, Topeka & Santa Fe Railway Company*, 464 F.2d 173, 175 (10th Cir. 1972). How this standard is to be applied also depends on the nature of the facts to be demonstrated. In *Azalea Meats v. Muscat*, 386 F.2d 5 (5th Cir. 1967), the Fifth Circuit held that due diligence rarely could be determined on summary judgment of the necessity of determining the state of mind of the individual charged. Although the standard applied in *Azalea* is strict, it is not absolute.2/ As will be explained *infra*, this is one of those rare instances in which summary judgment is proper.

In securities fraud cases under Rule 10b-5 federal courts apply the statute of limitations of the most analogous state claim. Recently in *McNeal v. Paine, Webber, Jackson & Curtis*, 598 F.2d 888 (5th Cir. 1979), a panel of this court held that Georgia's four year fraud statute of limitations3/ should be applied. Although the statute of limitations is supplied by state law, as a matter of federal law the limitation period begins to run from actual dis-

covery of the fraud or from when the plaintiff should have discovered the fraud by exercise of due diligence. Thus, the crucial factual issue in the instant case with respect to the commencement of the four year statute of limitations is when the plaintiff, through the exercise of due diligence, should have known of the existence of fraudulent conduct complained of and whether there is a genuine issue as to this fact. The policy behind the due diligence requirement is consonant with the policy behind the securities acts which is to protect innocent investors, not those who lose their innocence and wait to see how the investment turns out before deciding whether to invoke the protections of the law. *See Royal Air Properties, Inc. v. Smith*, 312 F.2d 210 (9th Cir. 1962). Among the critical factors relevant to a determination of due diligence is the nature of the claim,4/ the sophistication of the investor, the position of the investor and the industry,5/ whether the fraud has been concealed,6/ the opportunity of the claimant to detect the fraud and the claimant's knowledge of related securities proceedings. *See deHaas v. Empire Petroleum Company*, 435 F.2d 1223 (10th Cir. 1970).

In the instant case the position of the plaintiffs in the industry and their opportunity to detect the fraud cannot be emphasized too heavily. The plaintiffs were directors of one of the merging corporations. Not only does this imply sophistication and general knowledge of the merging process far beyond that of a shareholder, but it also implies a much greater opportunity to detect the fraud than a mere shareholder or purchaser would have. Moreover, the position of the investor as a director is important in relationship to the requirements of state law. In the appellants' dealings with their own shareholders and the management of the business of the corporation common law imposes a duty of

reasonable prudence on the part of a director.7/ Although this requirement is imposed in slightly different circumstances, this duty is nonetheless relevant to an analysis of the exercise of the appellants' diligence in protecting their own and the other shareholders' investments in the merged corporation. Given the position of the plaintiffs as directors, the knowledge that the appellants had received must be viewed in that light.

The appellees contend that four documents disclosed to the appellants should have satisfied both their duty of disclosure and at the very least given notice to appellants to inquire as to the alleged nondisclosures. Specifically, the appellees first contend that the documents disclosed the existence of a surplus loan certificate which in turn would have alerted the appellants that because this certificate was required, the insurance subsidiary was not in the best of financial health and the reserve requirements had not been met. These four documents include two notices of annual equity stockholder meetings, one for 1968 immediately prior to the merger and one for 1969 subsequent to the merger, a 1967 prospectus for the issuance of Equity's common stock and a Form 10K Annual Report for the year of 1967 filed pursuant to the Securities Exchange Act of 1934. Three of these documents referred to a time frame prior to the ripening of appellants' interest in the merged corporation, and even though the court might in another context8/ hold that the appellants as directors should have inquired into the financial status of the insurance subsidiary prior to a merger, we are not prepared to charge appellants with an absolute duty to have read these particular documents. Additionally, without more evidence than these documents, this court would not hold that the appellants had received such notice as to trigger an investi-

gation by a reasonable investor.

In addition to the documents, however, the appellees also have offered a 1975 disposition of appellant Smith in which he stated that he knew that the insurance subsidiary was "broke" sometime about 1970. The following exchange took place during the course of that deposition:

> Q And when did those conversations take place? The first time they told you that Equity Life had been broke before the merger—when was the first of those conversations?
>
> A They didn't tell me—Oh. If I understand your question, a year or two after the merger.
>
> Q That would have been roughly in 1970?
>
> A Close to that. Actually I think the real thing that divulged it, they came to me and to Barney particularly, I don't know the others, hoping for some help. In other words, they said we have got to do something to maybe hold this together, like put some money in it. Of course, I think then in place of doing that the decision was to sell it, sell the life insurance company.

The "Barney" referred to in the response is the other appellant McPherson.9/ This exchange demonstrates that the appellants had actual knowledge that the subsidiary was in financial difficulty five years prior to the filing of the complaint. Indeed, the fact that the insurance subsidiary was sold almost immediately after the merger, implies that appellants had actual inside knowledge of the difficulty very soon after the merger occurred. Of course, this knowledge is not identically congruent with the claim that the reverse fund violations were not adequately disclosed. However, they are connected sufficiently so that investigation of the

financial status of Equity would certainly have divulged the reserve fund violations. Thus, we hold that knowledge of the subsidiary's precarious financial position constitutes such notice of the fraud complained of as to require investigation by a reasonable investor in the position of the appellants as a matter of law. After the appellants were apprised of this information they took no action to inquire as to the financial health of the insurance company nor of the integrity of the disclosures made by the appellees with regard to the merger.

The facts that finally led the appellants to investigate also are relevant to the determination of due diligence and probable justification for the delay. The occurrences and knowledge that appellants argue resulted in their investigation were a suspect merger with Jordan Carpets, an airplane transaction with Ore Industries, excessive attorneys' fees, and mismanagement and fraud on the part of the board of directors. None of these are relevant to the Rule 10b-5 claim at issue. The following quote, however, tells us exactly why appellants waited to bring suit:

> Mr. McPherson and I went to a board meeting immediately after the stockholders meeting [in 1973]. Mr. Childs reaffirmed this statement [that the corporation was going downhill], and Mr. Wynn said that if it doesn't turn around we will ask him to resign and expect it. *And* when this time past and it did not *happen*, we began to wonder and question. In other words, there is a number of things that caused us to be suspicious and investigative.

It is apparent from reading the entire deposition that the number of things that appellant referred to were, cumulatively, that the company was not successful, and that he

waited to investigate because he wanted to determine how the investment would eventually turn out. It is precisely when the investor has lost his innocence and waits to see whether his investment will be for good or for ill that the due diligence requirement must be applied. *See James v. Atchison, Topeka and Santa Fe, supra.* Moreover, there is no dispute in the evidence that the appellants had knowledge prior to 1970 that the insurance subsidiary was in financial difficulty at the time of the merger. Because there is no dispute as to this fact and because this fact as a matter of law would constitute notice that the claimed violation had occurred, we affirm the district court's grand of summary judgment.

AFFIRMED

1/ The district court erroneously applied Georgia's two-year Securities Act statute of limitations, *Ga. Code Ann.* §97-114. As discussed *infra*, this error does not produce a different result because the action was also filed beyond the four-year statute.

2/ Moreover, because the due diligence requirement is objective, that is depending upon whether the plaintiff exercised reasonable diligence rather than when the particular plaintiff actually discovered the violation. *See McNeal v. Paine Webber Jackson & Curtis, Inc.*, 598 F.2d 888, 892 n. 11 (5th Cir. 1979).

3/ The four-year statute applicable to actions to redress personal injuries applies equally to actions based on fraud. *See e.g., Quinn v. Forsyth*, 116 Ga. App. 611 (1967).

4/ For example, churning is such an exotic form of

fraud that an unsophisticated investor would not be deemed to have failed to exercise due diligence even though he had notice of all the trades which constituted the churn. *See Dzenits v. Merrill Lynch Pierce Fenner & Smith,* 494 F.2d 168 (10th Cir. 1974).

5/ Thus, in *deHaas,* the plaintiff, a shareholder, was a mere investor on the industry not a participant and as such could rely on the officers of the defendant.

6/ *See generally Bailey v. Glover,* 88 U.S. 342 (1874).

7/ In Georgia this duty is provided by statute, *Ga. Code Ann.* §22-713. Indeed, the Georgia Court of Appeals has rejected a "do-nothing" defense to state securities action brought by shareholders against directors. In *Boddy v. Theiling,* 129 Ga. App. 273 (1974), shareholders sued the directors of their corporation for the unlawful sale of unlicensed securities. One of the directors moved for summary judgment on the ground that he "did nothing" with respect to the sale and therefore he had not "participated or aided" in the sale as required by the state Blue Sky Laws. The Court of Appeals based its rejection on the defense in part because of the duty of prudence imposed upon a director.

8/ For example, had a shareholder sued derivatively for breach of fiduciary duty as directors. *See* n. 7 *supra.*

9/ Although the deposition does not refer to Betty Cloud, it must be noted that when appellants filed their amended complaint they also filed a voluntary motion to dismiss without prejudice defendant Byars and plaintiff Cloud. The complaint as formally amended named only Smith and McPherson. Apparently, no action was taken on the dismissal.

APPENDIX B

Decision of the United States District Court, Northern District of Georgia *(Smith et al v. Equity National Industries, Inc. et al,* file no. C75-838A, dated September 12, 1977).

NEWELL EDENFIELD, U.S. District Judge, Presiding

This federal securities action under section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b), and Rule 10b-5 promulgated thereunder, 17 C.F.R. § 240.10b-5, is currently before the court on defendants' motion for summary judgment on Count I of the complaint, and defendants' motions to compel discovery and for a protective order.

The salient facts in this section were set forth in this court's order of December 22, 1976, and need not be repeated here in full. At that time the court dismissed all substantive counts in the complaint, with the exception of Count I. Defendants had argued that Count I was barred by the applicable statute of limitations, but the court was unable to so rule as a matter of law and therefore denied the motion to dismiss.

Plaintiffs were stockholders and directors of Hewitt Studios, Inc., which merged with defendant corporation (Equity) in October 1968. Count I alleged failure to disclose certain material facts in connection with that merger, which facts related to the financial structure and condition of Equity's insurance subsidiary. The material nondisclosures were that (1) just prior to the merger, Equity's insurance subsidiary had been informed that it was in violation of certain state reserve fund requirements, and (2) a substantial part of the subsidiary's earnings were derived from insuring the mortgage customers of a savings and loan

association whose president served on Equity's board of directors. *See* Order of December 22, 1976, at 2. While these alleged nondisclosures took place almost seven years before the complaint was filed, and any claim for recovery thus appeared to be barred by the two-year statute of limitations, GA. CODE ANN. § 97-114, plaintiffs sought to invoke the doctrine of equitable tolling of the statute. Plaintiffs argued that they had remained in ignorance of the fraud until 1974, and that they had exercised due diligence to discover the fraud in the period from 1968 to 1974. Plaintiffs were alerted to the problem in 1974 by Equity's financial reports, which indicated large losses. Order, *supra*, at 4-5.

As the court pointed out in its previous order, the "doctrine of due diligence only tolls the statute of limitations 'for those who remained ignorant through no fault of their own. Unawareness of facts or law, alone, does not justify suspending the operation of the statute,' " Order, *supra*, at 5 (citation omitted). The court found that

> [T]he status of Equity's insurance subsidiary, which was a major source of Equity's overall revenue, is a matter which the plaintiffs should have inquired into prior to the merger with Equity. By examining Equity's annual reports, the plaintiffs could have discovered that defendant Fisher was both a director of Equity and president of a savings and loan association. Since Equity's insurance subsidiary's business was the insurance of mortgage clients of such associations, they should have made an effort to determine whether Equity's insurance business was heavily dependent upon one or two savings and loan associations.

Order, *supra*, at 6. While the court found that plaintiffs could thus have discovered the allocation of the insurance

subsidiary's business, it nevertheless declined to rule out the possibility that plaintiffs could show that they had exercised due diligence and denied the motion to dismiss. Defendants have now renewed their contention by presenting additional factual material to the court and moving for summary judgment.

Defendants point to four documents which disclosed the existence of a surplus loan certificate. This certificate represents a loan from an Equity director to the insurance company, which loan was necessary to meet the state's reserve fund requirements. Knowledge of the existence of the surplus loan certificate and the circumstances surrounding its issuance would have alerted plaintiffs to the facts that the insurance subsidiary was not in the best of financial health and that problems with the state reserve requirements existed.

The four documents include two notices of annual Equity stockholder meetings, one for 1968 (prior to the merger) and one for 1969 (subsequent to the merger), a 1967 prospectus for the issuance of 160,642 shares of Equity's common stock and a Form 10-K annual report for fiscal year 1967 filed pursuant to the Securities Exchange Act of 1934. The most complete disclosure is found in the prospectus, while the other documents more or less indicate the existence of the loan without providing any extensive discussion.1/

Plaintiffs argue that all these documents pertain to the period prior to the time when plaintiffs became Equity shareholders,

1/ The prospectus was issued when the Equity National Life Insurance Company was reorganized into a holding company, with the insurance company becoming a

wholly owned subsidiary. The prospectus described the surplus loan certificate as follows:

> On June 15, 1967, in order to provide additional funds which were needed by the Company to augment its reserves, and before the present offering could be commenced, the Company borrowed $100,000 from Mr. Roscoe Winn, one of the Directors of the Company, and issued as evidence of its indebtedness a surplus loan certificate to Mr. Winn. The certificate provides that interest on the unpaid balance shall be at the rate of 6¾% per annum, payable annually. The certificate further provides that the principal sum shall be repaid promptly on demand by Mr. Winn, but only from that part of the surplus of the Company as [shall] exceed $200,000 and Mr. Winn is not entitled to demand repayment of the principal, or any part thereof, unless at the time of such demand the Company's surplus shall exceed $200.00. . . .

Prospectus at 7-8; *see also id.* at 3-4.

with the exceptin of the 1969 stockholders meeting notice, and that therefore they may not be charged with knowledge of their contents. While the court does not deem the time period to be wholly irrelevant, it has already pointed out that plaintiffs, as directors of Hewitt, should have inquired into the financial status of the insurance subsidiary prior to the matter. Such an inquiry would of necessity include review of Equity's annual reports for some period of time when plaintiffs were not Equity shareholders. However, the court is not prepared to charge plaintiffs with an absolute duty to have read these particular documents, and were these the only additional materials presented to the court on this motion, the court would deny defendants'

motion for summary judgment.

But defendants have also presented a 1975 deposition of plaintiff C. S. Smith in which he stated that he knew that the insurance subsidiary was "broke" sometime about 1970. The following exchange took place during the course of that dposition:

> Q. And when did those conversations take place? The first time they told you that Equity Life had been broke before the merger, when was the first of those conversations?
>
> A. They didn't tell me—oh. If I understand your question, a year or two after the merger.
>
> Q. That would have been roughly in 1970?
>
> A. Close to that. Actually I think the real thing that divulged it, they came to me and to Barney, particularly—I don't know the others—hoping for some help. In other words, they said we have got to do something to maybe hold this together, like put some money in it. Of course, I think then in place of doing that the decision was to sell it, sell the life insurance company.

This exchange clearly shows that both plaintiffs C. S. Smith and B. E. McPherson had actual knowledge that the subsidiary was having financial difficulty some five years prior to filing their complaint.2/ This knowledge should have alerted the plaintiffs and caused them to undertake an investigations which quickly would have disclosed, through the documents discussed earlier in this order, the facts upon which Count I is based. Yet no investigation was undertaken. See Plaintiffs' Response to Defendant's Interrogatory 8 (filed June 10, 1977).3/

2/ The deposition does not speak to plaintiff Cloud's knowledge. However, when plaintiffs filed their amended complaint on September 1, 1976, they also filed a motion to dismiss without prejudice both defendant James A. Byars and plaintiff Betty F. Cloud. The amended complaint therefore named only Smith and McPherson as plaintiffs. No formal action was apparently taken on Cloud's dismissal, although a consent order dismissing Byars was entered. As the parties have proceeded on the assumption that plaintiff Cloud was no long a party to this action, and there has been no opposition to this motion, Local Rule 91.2, plaintiff Cloud is hereby DISMISSED WITHOUT PREJUDICE. Rule 41(a) (2), Fed. R. Civ.P.

3/ Plaintiffs have argued that the deposition is subject to varying interpretations and thus is not an appropriate basis for a summary judgment. Plaintiffs point to an earlier portion of the same deposition, in which plaintiff Smith described the events which led to the investigation which resulted in this lawsuit. The court fails to find that this narration of events negates in any way the force of Smith's description of events occurring in approximately 1970. The crucial factor is not the point at which plaintiffs learned the actual facts on which the complaint is based. Rather, the question is the point in time at which plaintiffs had information available to them from which arose a duty to investigate if they wished to preserve their judicial remedy.

The mere fact that no action was taken does not show that due diligence was not exercised. But likewise the fact that plaintiffs remained in ignorance of the specific facts on which they based their claim does not indicate that those facts were concealed from them so as to toll the statute of

limitations. When plaintiffs obtained actual knowledge of a sort which would cause a reasonable investor to undertake some sort of investigation—the knowledge that the insurance subsidiary was "broke"—and still failed to take any action to protect their interests, the court must find that there was an absence of due diligence on their part. Plaintiffs could, and should, have discovered the allegedly material nondisclosures which form the basis for Count I of the complaint more than two years prior to filing their complaint. Defendants' motion for summary judgment with respect to Count I is hereby GRANTED.

The court need not decide the discovery motions before it in light of its disposition of the summary judgment motion. However, for future reference, the court notes that neither counsel remaining in this action has acted in an exemplary manner. Plaintiffs' attorney was extremely slow in responding to defendants' most recent set of interrogatories and the court sees no reason why more than six months were required in order to revise plaintiffs' interrogatories to defendants following this court's order of December 22, 1976. Defendants' counsel, on the other hand, has been extremely quick to resort to the court with discovery motions without indicating compliance with the local rule respecting conferences between opposing counsel, Local Rule 91.62. Nor has counsel indicated compliance with the court's December 22 order, which required that counsel confer over differences arising from plaintiffs' revised interrogatories before returning to the court. The court also notes that plaintiffs' attorney requested a conference in his letter transmitting the revised interrogatories, which request was apparently ignored. These cautionary words concerning discovery are written in the hope that such conduct will not be repeated when

either counsel returns to this court.

In summary, plaintiff Betty F. Cloud is DISMISSED WITHOUT PREJUDICE, defendants' motion for summary judgment is GRANTED, and all other pending motions are DENIED as moot. The clerk is directed to enter final judgment in favor of defendants.

So ORDERED, this 12th day of September, 1977.

NEWELL EDENFIELD
United States District Judge